

Pension Woes Across the Pond

Of the major developed economies, the U.S. tends to have the most in common with its Anglophone cousin, the U.K., as both have similar legal and business traditions, demographic trends, and consumer-based economies. In recent years, the U.K. has led the U.S. by a few months in several significant trends, namely the central bank tightening cycle and the much publicized housing bubble. Now the Brits appear to be a step ahead of the Yanks on an issue that will be of particular concern once our economy enters its next season: pension and social security reform. The results have not been particularly good, and Americans should take note of the problems faced by their English-speaking contemporaries.

Like the U.S., the U.K. faces a social security crisis in which the commitments to retirees will far outstrip the system's ability to pay. Now, in the midst of the Boom, these problems can be conveniently ignored by our policy makers. The Baby Boomers are earning and spending at record levels and keeping Social Security plush with cash in the process. Even the cresting of the Spending Wave in 2010, which will bring the Boom the grinding halt, will not immediately cause a pension crisis, as most of the Boomers will still be gainfully employed and paying their taxes. The true crisis period will start when the Boomers (read "your clients") retire en masse and expect to collect their Social Security checks, after our economy has already endured what is likely to be a severe contraction and investor portfolios have been ravaged by a secular bear market.

Forward-thinking policy makers, though perhaps not anticipating the recessionary period ahead, understand the pension problems we will face. The obvious solutions are, of course, a later retirement age, lower benefits and means or needs testing. The Economist, the well-respected financial weekly, outlines some the frustrations the British have faced in attempting to reform their system. For a glimpse of what you and your clients can expect, read on:

Must try harder

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From The Economist print edition

Ranking Britain's oldsters at work

IN BRITAIN, as in other advanced countries, post-war baby-boomers are approaching retirement. A smaller generation will replace them in the workforce. As a result, the ratio of people aged 65 and over to the working-age population is set to soar, and with it financial pressure on fewer workers and taxpayers to provide for more pensions. ...

[The Government] hopes to [meet its obligations] by concentrating spending on poorer retirees, notably through the means-tested pension credit which it introduced in 2003. But the policy has a fatal flaw. For it to work, employees on quite modest incomes will have to save more for their retirement. But the pension credit discourages them from doing this: it is withdrawn at a rate of at least 40% for every extra pound of savings income. Because state pensions are anything but lavish, almost two-thirds of all pensioners are expected to be eligible for the credit in 20 years' time. So this disincentive to save is affecting more and more workers.

On November 30th, the government-appointed Pensions Commission will map out an escape route from this policy dead-end. It will propose reducing the incidence of means-testing by making state pensions more generous, and would help pay for this by raising the state-pension. Gordon Brown, the chancellor, has already signalled

that he is worried about the potential cost of the commission's proposal, leading to speculation that the government will bin it...

It has been assumed by many commentators here in the U.S. that Social Security will be made solvent by phasing out benefits to the “wealthy,” effectively meaning anyone with a positive balance in their 401k. You should assume that your clients, who are far more likely to survive the downturn with their portfolios intact, will be among those who see their Social Security checks disappear. As the British have already discovered, this provides the absolute worst incentive for irresponsible behavior. When government pensions are only available to those who have not bothered to save for retirement...suddenly everyone becomes a spendthrift.

Though President Bush’s proposals for Social Security reform appear to be dead for the foreseeable future, the problems are not going away. There are no quick fixes. Pushing the retirement age forward to age 70 assumes that companies will want to continue paying graying employees in their 50s and 60s. Reducing benefits from their already parsimonious levels will leave many seniors unable to meet their expenses. And means testing, as the British have discovered, creates a new welfare system for the elderly, with all the negative aspects of the existing welfare system but without any of the potential for improvement – a welfare mom can be trained for a new career and integrated into the economy as a producer; an 80-year old grandfather, however, cannot be reasonably expected to contribute much.

Expect our politicians to get progressively more desperate as the promises made to the Baby Boomers slowly bleed the economy dry.